

TRADE POLICIES FOR RAPID DEVELOPMENT

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CONTENTS

FOREWORD

Most developing countries have announced that they will convert their economic development strategies from import substitution to export promotion. But the majority of them have not lived up to that announcement. This raises the question as to why there is a gap between rhetoric and reality. Several explanations are certainly possible, but two stand out. First and foremost is the intellectual power of the infant-industry argument, which says that positive externalities may justify temporary protection of some industries until they mature later. Secondly, the shift to more open economies is often resisted by powerful interest groups such as bureaucrats and protected firms. Bureaucrats resist reform because they benefit from discretion over the allocation of import licenses, and protected firms resist reform because they lose their rent and face more severe competition.

In this publication, Anne O. Krueger addresses in some depth the reasons why policymakers do not live up to their announcement, as well as other questions. She explains the reasons why import-substitution policies failed in the past, assesses the effect of outer-oriented trade policies on economic development, explores how to overcome the problems encountered in the reform process, and draws some preliminary conclusions for Egypt. In a nutshell, she makes a very persuasive case for reducing the bias against exports by providing incentives across the board. Her analysis draws substantially on the experiences of Chile and Korea, but extends to many other countries around the world. The result is a very thoughtful and informative paper.

The second part of the publication is equally informative. Participants wondered whether the Korean success in promoting exports is largely due to discipline and exchange control rather than openness, while others argued that Korea presents an example of what not to do in developing countries, because the world environment now is different from the early 1960s and because Korea had a more efficient bureaucracy than exists in most developing countries. There was also the view that liberalization may be fine in its own right, but may be inappropriate in a world environment in which developed countries protect their agriculture and impose quotas on developing countries. Professor Krueger's answer to these questions was unwavering in favor of liberalization. Many readers will undoubtedly find her insights in support of liberalization particularly relevant for Egypt, as the country is trying to make the transition to a more open economy.

Ahmed Galal
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September 1997

تقديم

كثيراً ما أعلنت معظم الدول النامية أنها ستغير إستراتيجيات التنمية الاقتصادية بها من الاعتماد على الإحلال محل الواردات إلى التوجه نحو تشجيع الصادرات. إلا أن أغلبها لم يف بما أعلنه. وهذا هو ما يثير التساؤل عن أسباب ذلك التباين بين القول والعمل. وعلى الرغم من وجود عديد من التفسيرات التى يمكن إبداؤها، إلا أن هناك تفسيرين بارزين لذلك، أولهما هو تلك الحجة القوية المتعلقة بالصناعة الوليدة، والتى تنادى بأن العوامل الخارجية الإيجابية قد تبرر الحماية المؤقتة لبعض الصناعات حتى يمكنها أن تقف على أقدامها. وثانيهما أن التحول إلى اقتصاديات أكثر انفتاحاً، كان غالباً ما يواجه مقاومة من الجماعات القوية لأصحاب المصالح مثل موظفى الحكومة (البيروقراطية) والمؤسسات والشركات التى تتمتع بالحماية. ويقاوم البيروقراطيون الإصلاح لأنهم يستفيدون من سلطتهم فى منح تراخيص الاستيراد، بينما أن الشركات تقاوم الإصلاح لأنها ستفقد الريع الناشىء عن الحماية، كما أنها ستواجه منافسة أكثر عنفاً.

وفى هذه الورقة تتناول آن كروجر – وبشىء من التعمق– الأسباب التى تدفع واضعى السياسات إلى عدم الوفاء بما يعلنون، إلى جانب موضوعات أخرى. كما تقوم بتفسير الأسباب التى أدت إلى إخفاق سياسات الإحلال محل الواردات فى الماضى، كما تقدم تقييماً لأثر السياسات التجارية الموجهة إلى الخارج على التنمية الاقتصادية، وتقوم بإستكشاف كيفية التغلب على المشاكل التى تواجه عمليات الإصلاح. ثم تستخلص بعض النتائج الأولية بالنسبة لما يجرى فى مصر. وهى–باختصار– تقدم أدلة شديدة الإقناع تدعو إلى تخفيض التحيز ضد الصادرات عن طريق تقديم الحوافز للجميع. ويعتمد تحليلها بشكل أساسى على تجارب شيلى وكوريا، إلا أنه يغطى أيضاً كثيراً من الدول الأخرى حول العالم. وكانت محصلة كل ذلك هذا البحث القيم المفيد.

ويلحق الجزء الثانى بالجزء الأول من ناحية فائدته وما يحويه من معلومات. فقد تساءل المشاركون عما إذا كان النجاح الذى حققته كوريا فى تشجيع الصادرات يعود إلى ما تتمتع به من النظام والانضباط، والرقابة على الصرف الأجنبى، أم أنه يمكن أن يعزى إلى الانفتاح. بينما زعم آخرون بأن كوريا تقدم نموذجاً لما يجب أن تفعله الدول النامية، لأن المناخ السائد فى العالم الآن يختلف عما كان الحال عليه فى الستينات، ولأن البيروقراطية فى كوريا، كانت أكثر كفاءة عما هو موجود فى معظم الدول النامية. وكانت هناك وجهة نظر تنادى بأن التحرير قد يكون أمراً طيباً فى حد ذاته، ولكنه قد لا يكون مناسباً فى مناخ عالمى تحمى فيه الدول المتقدمة منتجاتها الزراعية، وتفرض الحصص على الدول النامية، وقد قامت الأستاذة آن كروجر بتقديم إجابات شافية وافية فى مصلحة سياسة التحرير. ولعل القراء سيجدون–بلا شك– أن آراءها فى مناصرة سياسة التحرير، تجعلها ذات أهمية خاصة لمصر التى تحاول اجتياز مرحلة الانتقال إلى اقتصاد أكثر تحرراً وانطلاقاً.

أحمد جلال
المدير التنفيذى ومدير البحوث
المركز المصرى للدراسات الاقتصادية

سبتمبر ١٩٩٧

ABOUT THE SPEAKER

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Professor Krueger is immediate Past President of the American Economic Association. Earlier, she was chair of the commission on Graduate Education in Economics. She is a Research Associate of the National Bureau of Economic Research, Where she is co-director of the NBER–East Asia Seminar series and earlier directed projects on the Political Economy of US Trade Relations, Foreign Trade Regimes and Economic Development, and Alternative Trade Strategies and Employment, and co-directed the project on U.S. Trade Relations. She is a director of the Western Digital Corporation and the Nordson Corporation, and was a trustee of Oberlin College from 1987 to 1995.

She was awarded the Robertson Prize by the National Academy of Sciences in 1984, the Bernhard-Harms Prize from the Kiel Institute of World Economics in 1990, the Kenan Enterprise Award from the Kenan Charitable Trust of the University of North Carolina at Chapel Hill in 1990, and the Seidman Prize in 1993. She is a fellow of the Econometric Society, and of the American Academy of Arts and Sciences, and a member of the National Academy of Sciences.

Professor Krueger specializes in international economics and economic development. She has done consulting and research in a number of countries including Turkey, Korea, India, Mexico, Brazil, and Papua New Guinea. Recent books include *Trade Policies and Developing Nations* (Brookings, 1995); *American Trade Policy: A Tragedy in the Making* (American Enterprise, 1995); *The Political Economy of Policy Reform in Developing Countries* (MIT Press, 1993); *Economic Policies at Cross-Purpose: The United States and Developing Countries* (Brookings Institution, 1993); *Economic Policy Reform in Developing Countries* (Basil Blackwell, 1992); and *Swimming Against the Tide: Turkish Trade Reform in the 1980s* (with Okan H. Aktan, ICS Press, 1992). She is co-editor of *Political and Economic Interactions in Economic Policy Reform: Evidence from Eight Countries* (with R. Bates, Basil Blackwell, 1993).

She has held visiting professorships at Universities around the world, including Monash University and the Australian National University in Australia, the University of Stockholm, the University of Paris, Bogazici University in Turkey, the Massachusetts Institute of Technology, and Northwestern University. Professor Krueger's present work includes further research and writing in the field of policy reform in developing countries, the political economy of policy formulation, and US international policy toward the developing countries.

PART I

TRADE POLICIES FOR RAPID DEVELOPMENT

1. Introduction

It is a great pleasure to be here, and an honor to be invited to give this lecture. I have, of course, been acquainted with some aspects of Egypt's economic development problems and policies for many years. But I am greatly looking forward to a chance to learn much more at first hand, and to exchange views with Egyptian economists.

My assigned task is to discuss trade policies for development. Since developing countries' governments began taking responsibility for the rates of growth of output and living s tandards in the period after th Second World War, a great deal has been learned about the nature of policies that affect development prospects. Much of that learning has been based on research and analysis, both of the sorts of policies that were initially undertaken and their drawbacks, and of the experience of where policies were changed. And, while much has been learned, there are still gaps in our knowledge: it is easier to say what won't work than to say what will!

In this lecture, I propose to discuss alternative trade policies for development, and the experience of countries that have successfully adopted trade policies conducive to rapid economic growth. In so doing, I shall first discuss early trade policies, which were primarily focused on import substitution, and the reasons for their adoption. This will have the advantage of enabling an understanding of the linkages between overall development strategy and trade policy.

On the basis of that discussion, I then turn to the early experience with impo rt substitution, and the sorts of difficulties that arose. Thereafter, I turn attention to the alternative trade policy, normally referred to somewhat misleadingly as 'outward -oriented' or 'export-oriented.' The term is misleading because it implies a bias of policies toward exports, whereas experience indicates that in the absence of a bias toward import substitution, neutral policies are sufficient so that most developing countries greatly increase their participation in world trade. In

connection with those policies, I will discuss the successes that followed their adoption and the reasons for them. I conclude this discussion with an analysis of the factors that were essential for success of outward-oriented trade strategies in East Asia and elsewhere.

To know that an outward-oriented trade strategy, once under way, can yield big growth dividends is not much help without an idea of how to get that strategy entrenched. To that end, I then discuss the problems associated with trade policy reform and the key issues that must be rapidly dealt with if the policy is to have a reasonable prospect of enduring. Examples of reform in Turkey, Chile, and Mexico are briefly discussed. Finally, I provide some conjectures as to the relevance of the discussion for present-day Egypt.

2. Early Thinking about Trade and Development

Almost all developing countries in the 1950s had economies whose exports seemed to consist primarily of primary commodities. And the élite believed that the key to successful development was to achieve industrialization. They further believed that the only way to do this was to foster domestic substitutes for imported industrial products, that is, to undertake 'import substitution.'

There were essentially three basic ideas underlying support for industrialization through import substitution in developing countries. The first of these was the infant-industry argument. The second was pessimism about the possibility of developing exports of primary commodities. And the third, related to the second, was Arthur Lewis's theory of surplus labor.

If there was a logical flaw in the argument, it was focus upon industrialization, which in fact is the outcome of successful development but which can take place without satisfactory development, as people in many developing countries have learned. However, as Bates (1981:11) has pointed out, this was simply taken for granted:

> Like all nations in the developing world, the nations of Africa seek rapid development. Their people demand larger incomes and higher standards of living. Common sense, the evidence of history, and economic doctrine all communicate a single message: that these objectives can at best be secured by shifting from economies based on the production of agricultural commodities to economies based on industry and manufacturing.

To be sure, many economists recognized that there was confusion of cause and effect when emphasis was placed on pulling resources into industry; an efficient growth path would have witnessed productivity increases in agriculture and hence a release of resources for industry. [1] Nonetheless, the facile assumption that industrialization was necessary for modernization was generally taken for granted, and the infant-industry argument was then used as a rationale for relying upon import-substitution to achieve it.

As is well known, the infant-industry argument was (and is) the only generally accepted reason why temporary protection might improve global economic welfare in a world in which all other markets function competitively and prices appropriately reflect marginal rates of transformation and substitution. The basic argument is that in a developing country there could be a potential new industry, already established in the rest of the world, which might have a comparative advantage in the long run. Nonetheless, it might not be established without public support because of dynamic aspects of cost reduction and externalities generated by those starting it. In these circumstances, if the long-run gains from the industry are sufficient to offset the short-term losses associated with initial encouragement to it, it could be Pareto-optimal for the country and for the world as a whole to permit temporary protection (through a governmental subsidy to production or through a tariff) during the initial startup period.[2]

The theory of infant-industry protection needs little comment. If there are externalities associated with the presence of an economic activity, and if there are reasons to believe that the cost of the activity will fall over time,[3] it is certainly possible that it might not be privately profitable to undertake an economic activity that would be socially and presumably privately profitable in the longer term.

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[1] See, for example, World Bank, *World Development Report* (1986), for an exposition of the role of 'taxation of agriculture,' in economic development. However, by the 1960s, a number of 'dual economy' models and other expositions noted the need for agricultural development as a prerequisite for rapid growth of industry.

[2] See Baldwin (1969) for an exposition of the argument and a critical analysis of the circumstances under which it might be correct. Even those who are normally closely identified with the neoclassical viewpoint accepted the infant-industry exception as a practical concern in the 1950s. See the quotation from Haberler below.

[3] This fall might result from 'learning by doing,' from the training and greater experience of workers, from reaching a sufficient scale of operations, or from other factors. Baldwin's (1969) skeptical analysis of the likelihood that protection would induce the anticipated response in the face of forms of externalities or market imperfections normally alleged is the classic.

But as is well known, the argument that there may be infants does not prove that protection (as contrasted with production subsidies) will induce the desired growth of an efficient industry, nor does it provide policymakers with guidelines that can prevent abuse of the argument to support and protect firms where no externalities or prospects for rapid productivity improvement exist.

In the early years after the Second World War, economic policymakers in developing countries used the infant-industry argument as a rationale for imposing high levels of protection for domestic manufacturing industries. Whether it was genuinely believed that the infant-industry case was valid, or whether instead a desire for industrialization and self-sufficiency motivated these policies, is virtually irrelevant for present purposes, although it is very germane to the political economy of protection: the infant-industry argument was certainly seized upon and used by those wanting to legitimize their argument in seeking protection for themselves.

Because of the infant-industry argument, many economists initially tended to view protection of industry in developing countries rather benignly. Acceptance of the infant-industry case for protection (via production subsidy or tariff) was virtually universal. Gottfried Haberler, who was more skeptical than most, acknowledged the case. In his Cairo lectures, in 1958, he stated:

It is possible that the development of a particular manufacturing industry, or of manufacturing industries as a whole, will produce 'external economies' . . . which eventually will make those industries able to stand up to foreign competition without protection. But since these economies are slow in coming, difficult to foresee, and often of such a nature that private enterprise cannot well appropriate them, private initiative may not be enough to ensure their realization.[4]

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[4] Haberler (1988), pp. 50–51. In his introduction to the reprinted Cairo Lectures, Haberler notes that he now believes, in hindsight, that he "went too far . . . in trying to find justification for a certain amount of protectionism in the LDCs" (p. 11).

The 'infant-industry rationale' certainly underlay many defenses of the trade policies of the developing countries in the 1950s and 1960s.[5] Theory supported the proposition that protection to a new industry generating externalit ies dynamically *might* improve the present value of future welfare and in that sense be justified. For my purposes, what is important to note is that there was little consideration as to how government officials, even economists, would be able to ascertain the presence of an infant, much less determine how much assistance was justified on infant-industry grounds. Haberler (1988:52) himself noted that it would require 'judgment' to identify such industries, and that data on the basis of which objective calcul ations could be made were unlikely to be forthcoming.

In theory, of course, it is clear that a production subsidy would be preferable to a tariff (or a quantitative restriction) as an instrument for protecting an infant industry when conditions are satisfied. Most economists accepted the use of tariffs, in preference to production subsidies, as necessary consequences of governmental fiscal constraints in developing countries. However, in most developing countries, quantitative restrictions on imports were e mployed to protect new import-substitution industries.[6] Despite this, in the 1950s and 1990s, few questioned the losses associated with the use of quantitative restrictions, including outright prohibitions against imports, from import-substitution industries.

The widespread acceptance of the infant-industry argument as a rationale for policy clearly illustrates the views of economists toward markets and governments in the 1950s and 1960s. Government officials were regarded as able to ascertain which industr ies would eventually be

[5] The optimum tariff argument has also been used on occasion to justify developing countries, protection. There, the—usually nonprofessional—argument has been that the Lerner symmetry theorem demonstrates that an export 'tax is equivalent to an import tariff. It has then been asserted that most developing countries have some degree of monopoly power in one or more primary commodities and that protection to imports may therefore improve their terms of trade on optimum tariff grounds. The difficulty with this argument is that there is no basis for differential tariff rates among imports of commodities of which the country is a price taker because of monopoly power in export markets. At best, a uniform tariff might be justified under the Lerner symmetry theorem as imports might be regarded as a composite commodity. In practice, if a country possessed monopoly power in the international market in more than one commodity, the formula for determining its optimum tariffs would become complex. indeed.

[6] These restrictions usually became import prohibitions once domestic productive capacity was deemed to be established. In some Latin American countries, tariffs were used in preference to quantitative restrictions, but tariff rates were often hundreds, and occasionally, thousands of percentages of the international price. In practice they, too, were prohibitive.

profitable and then to provide temporary incentives for their startup. These same officials would then remove protection—presumably gradually—as the industry matured. Private entrepreneurs, by contrast, were thought to be unable to start these industries without government protection (due to externalities or other market imperfections) but to be able and willing to do so with protection. The question as to how government officials would obtain unbiased forecasts of streams of costs and benefits from self-interested entrepreneurs was not addressed.[7] Nor were questions raised concerning the incentives that would confront producers once protection was granted.

Interestingly, there was apparently no questioning as to how, even if a prospective infant industry did exist, government officials might recognize it. Moreover, there was no concern with the impact of protection on incentives—either to producers for cost control and quality or to the political process to prevent the emergence of vested interests for continued and often increasing levels of protection.

The underlying premises regarding markets and governments implicit in these policy prescriptions are obvious: there was a strong emphasis on the primacy of market imperfections: market failures were thought to be relatively strong, while it was assumed that governments could correctly identify and perform economic functions. Virtually no attention was given to the possibility that there might be government failure. An alternative view of markets and governments might have led to the conclusion that despite externalities and dynamic factors, the profitability of new industries would be so great that enough of them would anyway be undertaken by private entrepreneurs. In this view, one could have accepted that there were certainly opportunities for new industries that would generate positive externalities, which would have high initial costs, and that learning by doing and other factors would subsequently reduce them, where nonetheless the prospective private profitability was sufficient so that it would pay entrepreneurs to bear startup costs without government assistance. In this view,

[7] In some countries, this issue was avoided by deciding that government-owned enterprises should start production of industrial commodities previously imported. Bureaucrats who are operating parastatal enterprises, however, have the same interests in convincing other officials of their likely future performance as do private entrepreneurs. Moreover, the high costs of public sector production have been a major source of difficulty for developing countries. In Turkey, public-sector enterprises use three to four times as much of both capital and labor as private-sector enterprises in the same lines of activity. See Krueger and Tuncer (1982).

focus would have been on creating a climate of profitability generally, rather than on governmental determination of which industries would be the appropriate infants.

The 1950s and 1960s view of the government's ability to determine which categories of infants were worthy of support, the level of support desirable, and its time path, was therefore a fairly optimistic one. Simultaneously, the vision of the market was that it was unlikely to function sufficiently well to bring forth new industries that were economically warranted, and needed, at a minimum, 'guidance' from economic planners. The second line of argument for import substitution concerned the expectation that earnings from exports of primary commodities could not increase. Policymakers were concerned that primary commodity prices would inexorably decline, and that, indeed, growth might even be immiserizing.[8]

Pessimism about the future prices of primary commodities had several roots. Firstly, the Malthusian doctrine notwithstanding, many economists pointed out that the demand for primary commodities was price-inelastic. To be sure, that did not address the question of the income elasticity of demand, but it was nonetheless taken as sufficient grounds for questioning any growth prospects based on increases in primary commodity exports. Secondly, there was a belief that primary commodity prices had declined in the past. Although the empirical evidence in support of this proposition was at best controversial, it was nonetheless widespread, and used to buttress the argument that future prices of primary commodities would decline.[9] Thirdly, there was the experience with the Great Depression. The terms of trade for primary commodities had fallen between 21 and 45 percent during that period. After that experience and the difficulties most primary commodity exporters had adjusting to the lowered terms of trade, it was concluded that primary commodity exports were at best unreliable.

It therefore seemed inevitable that, with incomes expected to rise more rapidly than export earnings (and an anticipated income elasticity of demand for imports greater than one), there would have to be another way to meet the need for foreign exchange.[10]

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[8] For a review and critical analysis of the 'elasticity pessimism' literature, see Radetzki (1990), and the references therein. On 'immiserizing growth,' see Bhagwati (1987), chapters 3, 4, 5, and 6.

[9] For a brief review of this literature, and an examination of the factual basis for it, see Spraos (1980).

[10] There was also a widespread belief, again based in part on the experience of the Great Depression, that the developed countries would not permit rapid expansion of imports for developing countries. It therefore seemed

The third argument, surplus labor, encouraged policymakers to think in terms of capital as being the only scarce factor of production. This, in turn, induced people to think in terms of investment (and hence capital accumulation) as being the activity that would foster industrialization and development. The idea that human beings are different, with different aptitudes and skills, and that not all investments are equally productive and e fficient, did not emerge easily from this line of thought.

3. Early Performance

With respect to import-substitution policies, first investments were usually in relatively labor - using consumer goods. These investments appear, for the most part, to have yiel ded satisfactory, if not high, social and private real returns, as fairly large markets for those consumer goods existed, and factor proportions were reasonably well suited to most developing countries' factor endowments.[11]

Even so, with the benefit of hind sight it is evident that symptoms of difficulty were already appearing. Four types may be distinguished. Firstly, many countries experienced chronic or acute problems associated with much sharper increases in demand than in supply of food, much of which was attributable to a neglect of agriculture in the push for industrialization. Secondly, a number of countries encountered inflationary difficulties, often leading to or associated with problems in their balance of payments. Thirdly, most countries experien ced chronic 'foreign exchange shortages' and/or 'balance of payments crises.' Fourthly, those shortages in turn led to increasingly restrictive trade regimes, with a large number of attendant costs.

The bias toward industry in resource allocation and in ra ising protection clearly harmed agricultural production. Prices of foodgrains rose sharply in many countries as outputs failed to increase as rapidly as demand. Suppression of producer prices of export crops resulted in

inevitable that there should be 'import substitution' via infant industries in order to meet the increasing demand for imports.

[11] Fei and Ranis (1964), among others, have argued that the difference between the East Asian newly industrialized countries (NICs) and the other developing countries is that the East Asian NICs changed their development strategy after this 'easy' import-substitution phase had ended. In this interpretation, early development strategy was appropriate, but usually persisted long after it was no longer so productive.

smuggling commodities across borders, with loss of official foreign exchange earnings and attendant difficulties in financing imports purchased for investment in the public, or large -scale private, sector.

The second difficulty was also related to the drive to industrialization and affected the trade and payments regime adversely. That is, the resource demands associated with import - substituting industrialization, including both imports and domestic goods, seem always to have been underestimated, while the supply of resources was overestimate d. This seems to have been the result of skewing the resource allocation away from efficient patterns of utilization, but it resulted in inflationary pressures in the domestic economy. As those pressures intensified—in the era of fixed nominal exchange rat es—most developing countries experienced inflationary pressures in excess of world rates. That inflation led to increasing currency overvaluation and intense foreign exchange shortages, which required further controls and protection beyond that envisaged for import-substitution reasons.

The upshot of all of these factors was chronic 'foreign exchange shortage.' As import substitution progressed, the economy was increasingly dependent on imports of producer and capital goods, both to continue employment in i mport-substitution firms and to permit the rate of investment to attain the desired level. Foreign exchange shortages, however, restrained investment plans. 'Stop-go' cyclical patterns emerged, with years of slow growth resulting from slowdowns associated with payments difficulties.

These and related problems led the authorities to intensify controls, as scrutiny of applications and licensing procedures was stepped up. New regulations increased the economic costs of carrying out economic activities. Even so, administrative difficulties and regulations resulted in shortages of goods, loss of commodities (as when inadequate storage facilities resulted in losses of crops to mildew, rotting, or rodents), or reduced prices received for exportables (as when quality deteriorated or delivery dates became uncertain). Smuggling, evasion of the trade regime, and other reactions of the private sector resulted in intensified enforcement with attendant delays and other costs that created difficulty.

However, most problems of these types seemed to emerge in individual units and sections of bureaucracies; there was little reason for those coping with, for example, the deterioration in the quality of Turkish tea, to learn of similar problems in Sri Lanka. Thus they were largel y

regarded as one-off, unique to each individual situation, and not seen as indicative of larger or more systemic problems.

The result was, of course, a slowdown in growth rates. The slowdown was obscured in part by the stop-go patterns of production, and in part by cyclical fluctuations in the terms of trade and other factors. However, by the 1980s it became clear that the growth rate of countries that had continued to adhere to import-substitution policies had slowed down even before the worldwide recession and debt crisis, while countries that had changed policies were able to attain much more satisfactory growth.[12]

It was empirical examination of the actual patterns of protection, and their results, that began to undermine these views, especially when it came to the determinants of behavior within the governmental sphere. Studies of existing patterns of protection, and especially of effective protection rates, were influential. So, too, were analyses of the effects of protectionist policies in a number of developing countries.[13]

4. Alternative Trade Policies

Despite all the research and evidence, however, it took the experience of the East Asian countries to begin to persuade policymakers that there was a feasible and desirable alternative set of policies. By the 1960s, some East Asian countries were already breaking away from the import-substitution, government-control model of development. Taiwan had begun increasing incentives for exports and reducing reliance on government controls as early as the mid-1950s, and Hong Kong had a virtual laissez-faire economy. Korea reversed the earlier import-

[12] See World Bank, *World Development Report* (1983), for one of the early recognitions of the differential growth rates among groups of countries.

[13] A large outpouring of studies of structures of effective protection took place in the 1960s and early 1970s. Some of these found their way into the series of studies of industrialization in developing countries undertaken by Little, Scitovsky, and Scott (1970) under the auspices of the OECD. Special mention should be made of the analysis of India by Bhagwati and Desai (1970); especially in light of the highly articulate statements of Indian economic policy that had earlier been made, the evidence that policies in practice fell far short of these statements was especially damaging.

substitution policies in the early 1960s, and Singapore began its impressive growth after breaking away from Malaya in the mid-1960s.[14]

Efforts to understand why East Asian NICs were the first to change policies have provided descriptive accounts rather than convincing analyses of why countries decide to undertake policy reform. Hong Kong was a colony, and alternative policies were not a viable alternative. Korea was highly raw-material dependent, was incurring current account deficits of around 10 percent of GDP, financed by US foreign aid, and faced the prospect of a reduction in aid; without altered policies, growth was virtually inconceivable. Singapore, too, as a cit y-state was import-dependent. Taiwan, whose policies changed first, seems to have been heavily influenced by S. C. Tsiang.

Table 1 gives some data on their impressive performance. As can be seen, per capita incomes grew so rapidly that they were four to fi ve times higher in 1990 than they had been in 1965. Whereas in the mid-1960s the East Asian countries had been among the poorest in Asia and regarded as having the bleakest growth prospects, they had living standards among Asian countries second only to Japan by 1990.

At first, East Asian growth was little noticed or thought to be attributable to special circumstances, such as US aid to Korea and Taiwan. However, as growth accelerated, it gradually became clear that the East Asian economic performance was not a fluke: not only did exports, real GDP, and living standards grow more rapidly than in other developing countries but impressive economic performance was sustained in the late 1970s after the first oil crisis. Even in the debt-and-recession years of the early 1980s, the East Asian NICs resumed growth rapidly.

Table 2 presents evidence on their growth rates contrasted with those of other developing countries. Among the countries adopting the then more conventional economic policies, only Brazil is estimated to have grown as rapidly as the East Asian NICs, and many countries' real

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[14] For accounts of growth in these countries, see the works by Frank, Kim, and Westphal (1975), Mason *et al.* (1980), and Kim (1991) on Korea; Kuo (1983) on Taiwan; Lim and Lloyd (1986) on Singapore; and Findlay and Wellisz (forthcoming) on Singapore and Hong Kong. See also the papers in the symposium edited by Tang and Worley (1988) and the contrast between Korea's and Turkey's performance in Krueger (1987).

GDP growth was well below the rate of population growth. The contrast in performance became even sharper in the period 1973–80, after the first oil price increase. Egypt's rapid growth was attributable largely to the discovery of oil and the huge increase in foreign aid after the Camp David accord. If account is taken of the shifts in terms of trade (with Algeria and Egypt exporting oil and the East Asian NICs all being heavily d ependent on oil imports), the difference in economic performance was even more striking. By the 1980s, even those countries (such as Brazil, Kenya, and the Philippines) adopting import substitution that had earlier achieved fairly rapid growth were experie ncing

sharp slowdown in growth rates and the differences in performance became more evident still.

When the phenomenal growth rates of the East Asian countries were sustained, the first lessons that were learned pertained to the foreign trade regime. Wh atever else was evident about the rapid growth of the East Asian NICs, it was clear that all of them had altered their foreign trade regimes and abandoned policies of import substitution in favor of an outer - oriented trade strategy. Exporters were enabled to import needed inputs fairly freely. At first, incentives were provided for exporting over and above those entailed in the nominal exchange rate. This led economists to begin calculating effective exchange rates, adding the value of these incentives to the nominal exchange rate. The effective exchange rate estimates were fairly uniform and across the board, applying to all categories of exports, in comparison with highly variable effective exchange rates for various categories of imports and import -competing goods. Analysis demonstrated that the real effective exchange rate for exporters was maintained fairly constant over time, although reliance shifted from export subsidies and tax credits to use of the exchange rate itself to provide export incentives.

That exports responded to the incentive was and remains unquestioned. Moreover, the structure of the East Asian economies shifted, as the share of both exports and imports in GNP rose dramatically. Table 3 gives some data for Korea: the experience of the o ther NICs was very similar. As can be seen, export and import growth rates were almost incredible. The shares of exports and imports in real output increased continuously from 1960 to 1980. Although real output grew at an average annual rate of almost 10 p ercent over three decades, export and

import growth significantly outpaced the growth of GNP. [15] There was little question but that the shift to the outer-oriented trade strategy was a significant factor in bringing about the spectacular growth of exports, and that that in turn had contributed in a major way to the accelerated growth rate of GNP.

It was further noted that while there were export subsidies and other incentives, these were specified in terms of the rate of incentive per dollar of exports receiv ed, and generally were not commodity-specific. While there were many debates about the lessons for policy arising from the East Asian experience, there was no question that the reorientation of the trade regime had played a significant role.

Research on the effects of highly restrictive trade regimes in a number of countries, and on the experience of countries that had reoriented their trade regimes even partially, confirmed the importance of an outer-oriented trade regime. By the 1980s, few could dismis s the East Asian experience; instead, the questions were focused on an analysis of the factors underlying that experience that accounted for such rapid growth. A first and clear lesson, agreed by all, was that the rapid export growth in East Asian countrie s was an important factor in their overall performance. The role of the real exchange rate as a mechanism for efficient resource allocation (or more accurately, the role of an inappropriate real exchange rate as a misallocator of resources) was evident, and few could doubt its importance. This meant that incentives for exporting were fairly uniform across commodity groups, as there was little in the incentive structure that differentiated between exports by type of commodity. The dramatic response of exports in each of the East Asian countries also showed that the allocative signals and incentives given by the overall macroeconomic framework were crucially important and could not be overlooked if other countries were to attempt to achieve similar results.

[15] The export growth rate somewhat overstates both the importance of exports in GNP and the rate of growth of value added in exporting, because imports of intermediate goods that were reexported constituted almost half the value of Korean exports, which is higher than that for most economies, although it may be noted that Singaporean exports equal more than 100 percent of GNP! Prior to the early 1960s, it is likely that the value-added component of exports was considerably higher. However, that 50 percent figure was reached by the late 1960s, and the rate of growth of exports thereafter is probably an accurate reflection of the rate of growth of value added in exporting.

One question that arose related to whether in East Asia export substitution had replaced import substitution as a trade-development policy. Although researchers were able to identify some aspects of governmental policies that favored exports, it was clear that there were other, residual, elements of the policy regime that were biased toward import substitution. Overall, the evidence seemed to be that an outer-oriented economy was the result of a trade regime that was not heavily biased toward import substitution. Small, labor-abundant countries without many natural resources were ones that would find themselves producing a large fraction of their output for export, and importing many other commodities. This understanding was reinforced as Korea, Taiwan, Hong Kong, and Singapore continued to grow: their commodity composition of trade altered toward goods that were less labor-intensive in production.

Uniformity of incentives for exporting in small countries (relative to the international market) also meant that, when attempts were made to encourage the development of economic activities without comparative advantage, feedback was fairly rapid. The Korean authorities, for example, concluded that their economy was ready for the development of heavy and chemical industries in the late 1970s. Imbalances in the economy rapidly became evident, however, and the effort was rapidly scaled back (see Yoo, 1990).

Other factors that derived from rapid export growth and contributed to rapid overall growth in the East Asian countries were the ability of firms with comparative advantage to expand rapidly and to take advantage of indivisibilities and economies to scale, and the spur to productivity growth provided by competition in the international market. The result was rapid rates of total factor productivity growth (see Nishimizu and Robinson, 1984). The significance of the trade and payments regime was thereafter not in doubt. Even by the late 1970s, there was a discernible, albeit not overwhelming, drift toward somewhat less overvalued exchange rates, reduced reliance on exchange controls, and somewhat more attention to the incentives for exporting on the part of other developing countries.

There were, to be sure, many other factors that contributed to growth in the East Asian economies. In all, infrastructure was rapidly improved, as the capacity and efficiency of ports, telephones, domestic transport, and other facilities was expanded and improved to facilitate exports. Fiscal reforms had drastically reduced fiscal deficits, and inflation rates were very low

by the mid-1980s. Protection to domestic industries, where it had been present, was lowered and the payments regime liberalized.

One other feature of the East Asian experience deserves note. That is: real wages rose rapidly (see Krueger, 1987), and there is little evidence, apart from the period of short -lived heavy and chemical industry drive in Korea, of any deterioration in the income distribution. Indeed, most estimates suggest that income distribution in East Asia was an d remained significantly less unequal (see Chenery *et al.*, 1974) than that in many developing countries where the stated purpose of import substitution and related policies was to improve the relative and absolute living standards of the poor.

Thus there is now a fairly wide consensus that the East Asian economies were highly successful, that there were reasonably uniform incentives for exporting and importing, that rapid export growth was a central component of their growth experience and, in that regard, that there was little bias of the East Asian trade regimes toward import substitution. That the real exchange rate and other export incentives were available across the board to virtually any who could export is not in doubt. Precisely how policies interac ted and the relative importance of each is still a question on which there is ongoing research. Questions remain, also, as to the role of government in the development of the East Asian economies .But that an outward - oriented trade strategy is a prerequisi te for rapid growth seems to be beyond doubt.

5. Trade Policy Reform

When the first policy reform efforts were undertaken, they were decided upon usually by small groups of technocrats, often working in crisis or near -crisis conditions, with little benefi t of experience in formulating their programs. They knew that existing policies had failed, that there was a crisis on their hands, and that something had to be done. Economic theory provides quite a bit of guidance as to the desirable set of economic poli cies, but it is of little help in charting out a road map of how to move from existing policies to the ultimately desired ones with as much gain as possible and as little discomfort.

Over time, however, experience with reform has increased, and researchers have had an opportunity to study different reform programs and their outcomes. By now there have been

enough reform efforts—successful, partially successful, and unsuccessful—for analysis to provide some insights.

It is useful to start by sketching those aspects of reform programs about which there is fairly general agreement. Thereafter, I turn attention to some troublesome issues on which there remain many questions.

A first point concerns what is meant by policy reform. Mark Twain, the American humorist, is often quoted as having said that quitting smoking was easy—he had done it many times! Policy reform would be equally easy if naming a set of economic decrees 'reform' were by itself sufficient to do the job. Indeed, Brazil has had thirteen 'economic policy reform' programs (and five new currencies) since 1986! The main objective of the first 'cruzado' plan was to reduce the rate of inflation, which was then running at an annual rate in triple digits. The most recent reform program was launched when inflation was running at an annual rate in quadruple digits! To take another example, in the early 1960s the Egyptian authorities were confronted with a shortage of foreign exchange, and approached the International Monetary Fund for assistance. The IMF was unwilling to provide support to Egypt unless some policies were changed, including the exchange rate. Egypt desperately needed support, but did not want to change the exchange rate. Finally, they reluctantly agreed to do so. Subsequent analysis, however, showed that the Egyptian authorities had simultaneously removed tariffs and other surcharges on imports and imposed a tax on exports, so that the 'effective nominal exchange rate' was virtually unaltered!

Thus simply calling something a 'reform' effort does not make it one. Sometimes, the authorities are genuine in their desire to undertake reform, but too politically constrained to be able to make the necessary changes, and end up announcing 'reforms' which stand little if any chance of success. On other occasions, the authorities may be genuinely committed at the start of a reform program, but withdraw their support in the face of opposition or of initial economic performance less satisfactory than had been anticipated.

A second point that seems universal concerns initial conditions. There have been two common characteristics at the outset of most serious reform programs. Firstly, there has developed a national consensus that the old policies were no longer working. Secondly, most policymakers and informed citizenry perceive that there is an economic crisis, sometimes in an

accelerating inflation rate and sometimes in balance of payments difficulties (as, for example, being unable to service debts). Occasionally, the crisis is perceived as consisting of very p oor prospects for economic growth.[16] In Turkey in 1980, for example, there was a foreign exchange crisis so that—in midwinter in a cold country—there was little heat (and none even in the Parliament Building) and little petrol, and inflation was rising to a n annual rate in excess of 100 percent. However, that had happened twice before in Turkey, and in 1980 there emerged a consensus that there was no point in simply repeating the measures that had earlier been taken.[17] In Mexico, it was not the debt crisis of 1982 that prompted reforms, but the failure of growth to resume by 1985 that brought the realization that a crisis was at hand and something had to change.

A third generalization about reform is that if it is to be successful in stimulating more satisfactory economic growth, it will be an ongoing process: initial reforms can, and usually do, bring some benefits (although often with a lag), but sustaining economic growth at a satisfactory rate normally entails a series of reforms that bring about increasing ly efficient functioning of a variety of markets and delivery of infrastructure services. Korea is still in the process of liberalizing financial markets and capital flows, to name just two areas where reforms continue. Moreover, there have been reforms in public finance, in the tax structure, in regulations governing equity transactions, and many other areas since the early 1960s. Even industrialized countries continue to reform: the deregulation of US airlines and of financial markets in the United States, Europe, and Japan are but recent instances.

The fourth generalization concerns the policy domains in which action is normally required fairly early in the reform process. Although reform is ongoing, there are some issues that must be addressed early in the reform process if it is to have a chance of long -run success. These include change to make sure that the overall macroeconomic framework (including the nominal exchange rate, monetary and fiscal policy, interest rate policy, and the foreign trade regime)

[16] This seems to have been the motivation underlying Korea's economic reforms of 1960–63, after the American authorities announced that future aid levels would diminish.

[17] Those measures had been the classic elements of IMF stabilization programs.

can be conducive to growth currently and prospectively, and the correction of any other underlying major distortions.

Almost all reform efforts have begun at a time when public sector expenditures were well in excess of revenues, with consequent inflationary pressures (or, less frequently, offsetting large-scale foreign borrowing). Although few reformers have ever attempted initially to reduce the public sector deficit to zero,[18] there must be a sufficiently large reduction in the prospective deficit to persuade people that the reforms are 'serious' and to free resources for increasing exportables production.

The nominal exchange rate invariably requires adjustment in the initial stages of reform. This is both because a prior unrealistic exchange rate has normally induced speculative capital outflows and because a realistic exchange rate is essential if there is to be any hope of altering incentives to encourage a more rapid growth of exports and structural change in the economy.

Finally, as already mentioned, in some instances one or more deep-seated distortions must be addressed if there is to be hope of reform.

To varying degrees, each of these 'essential initial components' of a reform policy package was present in earlier IMF stabilization programs. The difference, starting in the 1980s, is that these measures are seen as preludes to fundamental shifts in the relationship between government and private sector in economic growth and an outer-oriented trade strategy, where earlier stabilization programs were seen as completing a necessary short-term adjustment.

The private sector must significantly alter its behavior if an outer-oriented trade strategy is to succeed. For this reason, relations between government and business must change, with business perceiving that its rewards will depend upon its performance in producing items demanded in the international economy in a cost-effective manner.

Initial changes in fiscal balance, in the nominal exchange and interest rates, and in other key policy variables must be undertaken in a way that convinces most people that the new alignment of incentives and rewards is not a transitory one. Thus constraints and regulations governing private-sector activity need to be removed, with appropriate generalized incentives

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[18] In situations of hyperinflation, such cuts have been undertaken. The Bolivian reforms of 1984 entailed such a drastic cut, but the inflation rate at the start of reforms was 40,000 percent per annum!

for linkages with the international economy replacing them. Measures must be taken to increase the efficiency of public sector expenditures, while simultaneously moving further toward fiscal balance and amending the tax structure to remove distortions and bro aden the revenue base. Not only is a change in the nominal exchange rate normally essential in early stages of reform, but a mechanism needs to be found to maintain that exchange rate in real terms. In fact, it is essential not only that the exchange rate be realistic but that exporters be confident that it can remain so. The way this is most frequently done is by introducing a crawling peg, so that the authorities frequently make small adjustments in the nominal rate to take into account any differences in the rate of price increase between their country and that of their major trading partners. Alternative means for achieving the objective can include permitting the exchange rate to float and maintaining price level stability.

It was already mentioned that import prohibitions have to be removed and high tariffs reduced. This need not happen initially, but if the intent is to shift development strategy from reliance on inner-oriented mechanisms to an outer-oriented one, again the initial signals must be very clear and enough must be done to convince those who are deciding on how to allocate resources that the rewards for exporting are permanently increased. Indeed if businesspeople are at all skeptical about the prognosis for the reform effort, it is a near c ertainty that they will not change their behavior simply because of an announcement that reforms are coming. Enough must be done to persuade observers that reforms are serious and will last.

Indeed, to increase the relative return to producing exportables it is desirable to increase the price of foreign exchange (and assure that the new relative return will endure), while simultaneously reducing high tariffs and eliminating import prohibitions. [19] This process need not be completed in the initial stages of re form, but sufficient initial steps must be taken so that decision-makers within the economy are persuaded that the new and altered incentive structure will persist. Moreover, there is less pain in removal of import prohibitions and tariff reductions when they are accompanied by an increase in the real exchange rate than when they are

[19] At a minimum, from the beginning of a reform program, exporters need to be able to obtain any desired inputs from abroad without delay or unnecessary paperwork. If the reform program meets with initial success, further liberalization of the import regime must take place, but it need not all be at the initial step.

undertaken at a given real rate. The argument for removing quantitative restrictions on imports and for lowering tariffs in the early stages of a reform program is therefore co mpelling.[20]

Another area where action is generally desirable is in the financial markets, and particularly with regard to interest rates. As part of the effort to have government 'guidance' of economic activity in earlier development strategies, nominal int erest rates were kept low and credit was effectively rationed. In many countries, low nominal interest rates made borrowing very profitable, as real interest rates were negative. Although reforms need not necessarily entail immediate moves to market-clearing interest rates, all successful reform programs have entailed the raising of nominal interest rates to at least equal the rate of inflation. This seems to be desirable because it prevents the most wasteful use of scarce resources: negative real interest rates make almost any borrowing attractive, and insuring that borrowers must repay at least what they borrowed in real terms appears to cut out some excesses. [21]

Once these initial reforms are undertaken, a successful program will entail continuing changes in a number of markets. Exactly which these are varies considerably between countries, depending on the policies in place at the start of the reform process. In most countries, continued lowering of tariffs and moves toward a more open trade regime are an important part of the process. Other reforms, including the tax regime, public sector enterprise, and labor market laws, can be important depending on the initial situation in the country. In Turkey, for example, reforms began in 1980 and all quantitative r estrictions on imports were removed by 1983; a major tax reform was implemented at the beginning of 1985, as a value - added tax was introduced.

In many countries, the earlier set of policies resulted in a major bias against agriculture. In those cases reduction or removal of that bias has been an important component of reforms. To some extent, that removal happens simply by a move to a more realistic real exchange rate

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[20] It may be noted that, to the extent reduction of inflation is a major objective of a reform effort, reduction in tariffs and removal of quantitative restrictions early in the program helps in achieving that objective.

[21] Most reform programs have been followed by significant increases in savings rates. It is not clear whether these are a function of the higher real return to savings that becomes possible when banks can charge higher rates on their lending, or whether higher savings are a function of a more rapid rate of economic growth. Nonetheless, the changes can be spectacular. In the Korean case, for example, national savings were less than 2 percent of GDP in the late 1950s, and rose to over 30 percent of GDP by the 1980s.

(because many agricultural commodities are exportable, and the world price, translated thr ough the exchange rate, determines the domestic price). In Chile, for example, once reforms were under way, fresh fruits and vegetables became major crops, and exports grew rapidly. Earlier, these crops had not been sufficiently profitable. Rural incomes g rew not only because of direct farm employment opportunities, but also because of off -farm employment in processing, packaging, and shipping agricultural exports.

In some countries, regulations and laws (or union power) have resulted in high labor costs relative to labor productivity. Sometimes the costs are direct wages. Sometimes, however, they are indirect costs such as social insurance taxes, requirements that employers provide housing, or training. Sometimes, too, regulations preventing dismissal of wo rkers makes the employment of additional labor a long-term commitment. Regulations such as these provide a strong incentive to substitute capital for labor, and often need attention during reform programs. Moreover, for countries whose comparative advantag e would lie in significant part in labor-intensive goods, regulations governing the labor market can prevent any hope for significant export growth. In Papua New Guinea, for example, the real wage was indexed at a level more than three times that of the Ph ilippines, although there was no evidence that Papua New Guinea workers were any more productive than their Philippine counterparts, and transport costs are higher in Papua New Guinea. Even a realistic exchange rate and stable macroeconomic policy failed to induce investment in any significant manufacturing activities while that regulation was in effect.

Attention to public sector enterprises also becomes important as the reform process continues. Reduction or elimination of deficits, with their drain on pu blic resources, is one objective. But so too is more efficient operation, especially of ports, communications, domestic transport, and other infrastructure.

In many countries it has been important to introduce domestic competition. Much of this happens automatically by opening up. But for state-owned enterprisess (SOEs), this may require removal of restrictions on private entry if exporters are to have access to inputs at competitive prices. For example, in some countries private marketing of some goods has been prohibited, and removal of that prohibition has resulted in significantly more efficient

distribution. Sometimes, for both SOEs and private firms, introducing competition is easily achieved by removing import prohibitions.

It needs to be repeated that not all countries' economic situations at the outset of reform are the same, and the issues that require urgent attention, and that have the highest payoff, differ from country to country. Nonetheless, most analysts would cite the policies indicated abov e as being among the most frequent requiring reform. For trade reform to provide the payoff it should, reforms need to go far beyond the trade regime itself. Table 4 provides an indication of the sectors covered in a number of countries' reform programs. A s can be seen, most countries have undertaken measures pertaining to a wide variety of sectors. In successful cases, reforms have generally continued over time ultimately with extensive changes in the nature of government business relations.

6. Problems that Arise in the Reform Process

If reform were straightforward and guaranteed to deliver immediate benefit to all, it would already have been undertaken everywhere. In fact, there are a number of problems associated with reforms that inevitably make the pro cess a difficult one. Although some reform programs have been more painful and less successful than they might because policymakers made key mistakes,[22] some problems are inherent in the process itself.

Firstly, and perhaps most importantly, earlier polic ies build up groups with a vested interest in the continuation of those policies. Consider, for example, the businessman who builds a factory under import substitution, believing that he will receive protection from international competition. Removal of im port prohibitions and tariffs is, for him, a serious problem. When

[22] A classic example is Chile. In the late 1970s, the government decided to 'pre-fix' the exchange rate in an effort to control inflation. Inflation instead continued, and the real exchange rate consequently became increasingly overvalued in the subsequent three years. Finally, a change in policies was undertaken. It can be argued that Chile's reform process took three years longer to deliver results than it would have without the 'pre-fix.'

import-substitution policies have been in effect for decades, the extent of opposition to reforms, and support for perpetuation of the import-substitution regime, is large.

To a considerable degree, entrepreneurs are able to adjust to altered incentives with much less difficulty than they anticipate. Some discover that the availability of an imported input reduces their costs by more than they lose through protection. Others are able to narrow their product line and focus their activities on goods that they produce cheaply enough to compete in international markets. Nonetheless, the whole point of altering incentives is to spur increased economic efficiency, and that requires change and adaptation on the part of producers. They are naturally resistant of the process, in part because it is unknown.

In Mexico, for example, a businessman whose factory produced refrigerators for the domestic market was one of the leading opponents of Mexico's reforms. Mexican refrigerators were widely believed to be unable to compete with foreign ones. Once trade liberalization had taken place, however, the refrigerator producer discovered that he could import compressors. Earlier, domestically manufactured compressors had been used. These had had a short life expectancy and required frequent replacement. Once the imported compressors were used, the businessman was able not only to compete with imports in Mexico, but also to export. Indeed, today, that firm accounts for a sizable share of the US market in apartment-sized refrigerators.

In addition to political opposition, however, there is another 'attitudinal' problem. That is, what is being attempted is a thoroughgoing change in the structure of incentives. In part because there is bound to be political opposition, but in part by the nature of circumstances in which reform is undertaken, there is bound to be uncertainty as to whether reforms will be successful.[23] This issue has come to be termed the 'credibility' issue in the literature. In order for reforms to succeed, it is imperative that they be 'credible,' that is, that market participants believe that they are permanent. During the period of uncertainty, those economic activities such as import substitution, for which incentives are reduced, will clearly be reduced. Until people are confident that the new incentive structure will persist, however, they will be reluctant to invest in activities that are newly profitable

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[23] This uncertainty is all the greater, the greater the number of past failed reform programs.

The upshot is very likely to be a period during which economic activity is either declining or growing very slowly.[24] Doubts among those unemployed or concerned about their future, combined with the opposition of the vested interests that grew up around the old incentives, increase political opposition to the reforms. That opposition, in turn, reduces the credibility of reforms, which then increases the duration and intensity of the slowdown in economic activity, further undermining credibility.

The danger here, of course, is that if the slowdown is sufficiently protracted, opposition will mount to the point where the initial reforms are reversed or the process is halted. This period when reforms seem to hang in the balance has been encountered in almost all countries undertaking reform. All that reformers can do is to move as rapidly and decisively as possible, both in order to make the returns to those who do believe in the new incentives as attractive as possible, and to make the reforms as credible as possible. The issue is most acute in countries with prior histories of failed reform programs, such as Brazil.[25]

Another issue that has frequently been raised is the question of the 'timing and sequencing' of reforming. Here, many questioned how fast changes should be made, and the order in which liberalization measures and other changes should be made.

The timing issue is closely related to the credibility issue. Proponents of 'gradual' reform have argued that the dislocations and pains of reforms may be eased by moving slowly. While that may be true if credibility is not affected, gradual reforms give time for the opposition to mount, and may give the appearance of hesitancy on the part of the reformers. As experience with reforms has accumulated, the arguments for going fast appear to be stronger. On one hand, there are experiences such as the Polish, where a 'big bang' seems to have provided more immediate results with no greater discomfort than have some of the slower reforms of other

[24] In some countries, the increased availability of imports, a good harvest, or rapid change in expectations has meant that there was no such pause. Those experiences are the exceptions rather than the rule, however.

[25] However, even countries that have successfully carried out reforms, such as Chile and Turkey, had earlier episodes: Turkey in 1977 and 1978 and Chile in 1956–57 and 1958–59. It is often forgotten that Spain's spectacularly successful reforms of 1958–59 were preceded by a failed reform attempt in 1957.

Eastern European countries. On the other hand, a number of preannoun ced programs have had to be abandoned in the face of opposition.[26]

It has already been pointed out that reforms cannot, in any event, all be undertaken at once. Tax reform, prioritizing and streamlining public expenditures, restructuring or privatizing of SOEs, and a number of other measures inevitably take time. That much said, however, the weight of the evidence is increasingly on the side of haste: speeding up the time (and the number of new activities) at which people believing in the sustainability of r eforms find it profitable to allocate resources based on the new incentive structure appears to be the important consideration in minimizing adjustment costs.

The sequencing issue is a little different. It has already been seen that some initial measures need to be taken quickly, and that some take time. Early analyses of reform programs, however, asked a more general question as to whether some markets (for example, the labor market) needed to be well-functioning before others (for example, trade liberali zation) should be reformed. Some have questioned whether there is any point in opening up to foreign trade if domestic inflation is unabated.

There is not a universal consensus on these issues. There have been a number of countries that have liberalized on trade account before inflation was well under control (Korea in 1960, Poland in 1991, Turkey in 1980, Chile), and as long as measures are taken to reduce the size of prospective fiscal deficits, it would appear that there can be benefits from trade libera lization.[27] To be sure, those benefits will be greater the less the excess demand in the domestic economy, but it seems clear nonetheless that benefits accrue.

To date, there are no instances documented in which a goods market was liberalized 'too soon.' On the factor market side, there appears to be a growing consensus that it makes little sense to open the capital account before liberalizing current account transactions, although restrictions governing foreign direct investment and other long -term capital inflows can generally be relaxed in the early stages of reform.

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[26] In 1977, the Argentinian authorities announced a five-year program for the reduction of tariffs. They managed only to complete the first two years before opposition led to abandonment of the program.

[27] Indeed, insofar as it takes time for businesspeople to develop contacts in foreign markets and to start exporting, there are strong reasons for providing incentives to get started as soon as possible.

In general, political constraints on reformers are normally sufficiently great that they would be well advised to move as rapidly as possible, and to liberalize whatever markets they can. While there are occasionally 'bottleneck' sectors such as I discussed above, there is no evidence that liberalization of other sectors has harmed economies: only that benefits have not been forthcoming as they might have in the absence of those 'bottlenecks.' The argument for proceeding is that, once the bottleneck is removed in the future, there will be larger benefits from the reform.

This leads to the last criticism of reform programs that is frequently heard: that reform is harmful to the poor. It is certainly true that reduction or elimination of some welfare transfer programs is inevitable when these have become high-cost large drains on public-sector finances. High-cost welfare programs, however, are often discovered to have a large component of waste. As such, it is often possible to find low-cost substitute programs that deliver as much, if not more, to the poor, at lower cost than the earlier ones.

Moreover, the greatest victims of slow growth are the poor: it is they who stand to gain most with new jobs, better terms of trade for agriculture, and the other changes that reform can bring. The beneficiaries of the old import-substitution, inner-oriented policies are those who oppose reform most vehemently. They are usually not only not poor, but among the better-off in society, having profited from the various provisions of the old regime.

The challenge, therefore, is to find means of targeting programs for those poor who are genuinely adversely affected by the removal of earlier subsidies. This can be done in a variety of ways. In Chile, a mother–infant care program (which also provided nutrients for children under two years of age) and a government-sponsored employment program for those seeking work turned out to be fairly low-cost and effective. In Turkey, an agreement was reached under which the unions lost their power to strike and insist on increases in real wages but employers were constrained from dismissing workers for five years. The result was that employment did not grow during the first year of the upswing, but dislocation appears to have been greatly reduced.

Overall, if reformers can get through the period of uncertainty to the point where most believe that the new incentive structure is permanently in place, the major challenge is to maintain the momentum of reform. While judgment has to be exercised as to the relative

importance of next moves in different aspects of economic policy, it is probably more important to maintain the perception of ongoing liberalization than it is to identify the pre cise order in which reforms 'ought' to be undertaken.

7. Experience of Successful Reformers

I already mentioned that uncertainty is a major enemy of successful reform: people do not know how they will come out, and are naturally afraid of change. Usually, as well, people in countries where economic growth has been sluggish behind high walls of protection for inefficient public and private firms do not believe that their countries' economies are capable of better economic performance. Once that performance starts, political support for economic reform begins to increase. If the reform process is not aborted, accelerating growth provides more political support, which in turn permits the reformers to take further measures to improve economic performance, and a virtuous circle results.

To end this lecture, therefore, I want to concentrate for a few moments on the outcomes of some successful reform programs. Before doing so, however, I should note one often forgotten phenomenon. That is that, strictly speaking, a nalysis of the effects of reform programs should be carried out by contrasting the state of the economy with what it would have been in the absence of reform. Such a contrast is seldom made, and when reforms are less than spectacular, or when economic performance is mediocre, there is a tendency to regard that as 'failed' reform.

In fact, even in instances where reforms are less than spectacularly successful, there is good ground for believing that economic performance is better than it would have been in the absence of the attempt. Inflation may not be significantly reduced, but it may have failed to continue to accelerate; foreign exchange difficulties may not have ended, but imbalances and dislocations may be significantly reduced from what they earlier were. Perhaps the best

rapidly in the early to mid-1980s: cocoa production was down to a small fraction of what it had been two decades earlier; the black market exchange rate was 900 times the official rate; real income per capita had been falling an estimated 2 3 percent per year; and government

revenues were declining, with the result that most public services were unattended. After a reform program starting in 1984,
been around 5 percent. There remain many economic problems, and reform was by no means complete. But it seems clear that unless something had

been done, economic retrogression would have continued; contrasted with a rate of decline of 2–3 percent, a positive 5 percent seems fairly impressive. Judging Ghana's reforms fairly, therefore, is not possible without an estimate of what the alternative would have been, and the same is probably true of many other countries where reforms have been less far-reaching than those of Turkey and Chile, discussed below, but have nonetheless yielded considerable benefits.

When examining successful reforms, the countries that come to everyone's mind are Taiwan and Korea, two of the 'tigers' of East Asia that changed economic policies in the mid-1950s and early 1960s respectively. Partly because their stories are already very well known, and in part because so many observers believe that events of thirty years ago may not have relevance to today's problems, I choose instead to focus on Chile and Turkey, two countries whose reforms have been much more recent.

Let me turn to Turkey first. Table 5 gives background data. Turkey had had fairly rapid growth in the 1950s, until inflation and a balance of payments crisis led to a stabilization program in 1958. The crisis was manifest in a number of ways: critically, however, Turkey has no domestic oil, and had already exhausted suppliers' credits. By August 1958 it became evident that there would be no oil or petrol with which to harvest or transport the crops unless something was done. The stabilization program allowed the resumption of imports, and provided for fiscal and monetary restraint, along with a major exchange rate realignment. The program was evidently successful: real GDP rose 5 percent in the year following stabilization, inflation fell from 25 percent to 5 percent, and the deficit in the current account was reduced to sustainable levels. There had followed a decade of satisfactory growth (but at a rate below that of the early 1950s), and then foreign exchange shortages once again began to mount. In mid-1970 came a second major stabilization program, which was again followed by resumed growth. However, growth was somewhat slower, and inflation accelerated after 1970. Turkey

was hard hit by the oil price increase of 1973, but despite the adverse shift in its terms of trade and its rapid inflation, the exchange rate was adjusted only partially, and with lags.

By 1976, foreign exchange difficulties and inflation were pronounced. Table 5 gives some indicators of economic performance then and since. As can be seen, the current account deficit was as large as Turkish exports in 1976, although real GDP had been growing rapidly. Starting in 1976, growth began slowing rapidly, and averaged only 2.4 percent over the next three years—just slightly above the rate of growth of population. There were two stabilization programs negotiated with the IMF, but each was abandoned within a fairly short period of time.

By 1980, once again, the lack of foreign exchange and exhaustion of all credit lines led to reductions in output levels: many factories were closed, buildings were unheated in a cold Anatolian winter, and cars and trucks were idle for lack of petrol.

In 1980, however, when a reform program was announced, there was an underlying consensus among most Turks that the former economic policies had failed and could no longer be relied upon as a development strategy. In consequence, from the outset it was stated that the 1980 program was intended to alter the fundamental structure of the Turkish economy. In particular, governmental controls were to be largely disbanded, with greater reliance on markets and private enterprise to produce growth. Moreover, the import-substitution strategy which had been followed since the early 1950s was to be abandoned in favor of an outer-oriented trade strategy. In addition, the prospective fiscal deficit (well over 10 percent of GDP in prospect, with large deficits incurred by State Economic Enterprises) was to be sharply curtailed.

The results for the first several years were not unlike those of earlier programs. The inflation rate fell, and the current account of the balance of payments improved sharply. Real GDP grew somewhat more rapidly than it had in the late 1970s, but not dramatically. However, exports more than doubled in the first three years of the program (see Table 5).

By the mid-1980s, Turkey's economic growth was accelerating rapidly, and it averaged well over 6 percent for the period 1983–92. The growth was led by exports: exports grew at an average annual rate in excess of 20 percent, increasing their share of GDP from a mere 5 percent in the late 1970s to over 20 percent by the late 1980s.

As can be seen, the Turkish authorities maintained the real returns to exporters by permitting a real depreciation of the Turkish lira. In addition, in the early years of the program, the fiscal deficits were reduced substantially.[28] Inflation fell from its peak rate of over 100 percent in 1980 to a low of 31 percent in 1982 before it began accelerating again.

In the Turkish case, microeconomic reforms were extensive. All quantitative restrictions on imports were removed, and tariffs were lowered so that the highest tariff in the early 1990s was 35 percent. Barriers to exports were removed, and imports of goods used by exporters were permitted automatically and duty-free. The tax structure was reformed, and the financial system greatly liberalized. The Turkish lira was rendered convertible on current account.

The consequences were dramatic. As already mentioned, exports grew sharply, despite the fact that the reforms started in the early 1980s during the most severe worldwide recession since the Second World War. But the quality and variety of goods available to domestic consumers also improved dramatically. An earlier suspicion of the business community as incompetent monopolistic producers of low-quality goods was replaced with a view of Turkish businesspeople as competent exporters who could meet competition in international markets.

Turkey experienced a decade of highly satisfactory growth following the initial reform period, although fiscal discipline was not sufficiently adopted. By the early 1990s, fiscal deficits were soaring, and inflation accelerating. In the winter of 1994, an international rating service downgraded Turkey's foreign debt, and the government responded with another austerity program, the results of which are not yet known. Despite that, Turkey was able to enter into customs union with the European Union (for all manufacturing goods, but not agriculture) with hardly a ripple for the domestic economy.

Despite the unhappy—to date—macroeconomic ending to the reform, the Turkish economy was transformed during the decade of rapid growth. Although many challenges remain, the Turkish economy is much better situated today relatively and absolutely than it was seventeen years ago to meet future challenges.

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[28] The numbers given in Table 5 fail to take into account the deficits of State Economic Enterprises, which themselves were in excess of 6 percent of GDP in 1980. They were reduced to less than 2 percent by 1985, and rose thereafter. If those deficits are added to the central government figures, the swing in public finance is much more pronounced than is indicated in Table 2. See Krueger and Aktan, 1992.

Whereas Turkey experienced a rapid and dramatic turnaround in economic fortunes, but with microeconomic success and macro failure, Chile's reforms were much slower to bear fruit; but when they did, growth was dramatic and sustained. Table 6 gives some basic indicators.

It will be recalled that in 1973 General Pinochet succeeded Salvador Allende as president. The inflation rate at that time was in triple digits, export earnings had fallen drastically, and imports and domestic production were shrinking. During the first three years of Pinochet's rule, activities that had been nationalized under Allende were privatized, the fiscal deficit was eliminated (note in Table 6 that there was a surplus of 1.4 percent of GDP by 1976), and the current account deficit was closed. Real economic activity fell, however, from the inflationary heights to which it had risen in 1972–73. From 1976 to 1979, progress was made as the real rate of growth exceeded 8 percent, and inflation fell further (from 167 percent in 1976 to 33 percent in 1979), and exports increased by more than 50 percent.

However, desirous of really eliminating inflation, the Chilean authorities adopted the 'pre-fix' exchange rate. Inflation did not immediately fall, so the real exchange rate appreciated. This policy mistake would in any event have been costly, but coming as it did at the same time as the second oil price increase and the worldwide recession, the consequences were even more severe. In particular, the price of copper fell sharply, but private international lenders regarded Chile as creditworthy, so that borrowing, and hence total debt, increased.

As can be seen, the dollar of value export earnings in 1982 was below that in 1979 (in part due to the much lower price of copper), and real GDP fell from 1979 to 1982. It was not until 1985, when the nominal exchange rate was significantly adjusted and other policies were altered, that really satisfactory growth resumed. Exports virtually doubled between 1985 and 1988, and real GDP growth was in excess of 6 percent per year. Because Chile's population growth rate is very low, that translated into an average annual increase in per capita income of more than 5 percent.

It may be noted that Chile's fiscal deficit was eliminated, and with it inflationary pressure has been greatly reduced. The top tariff r ate is now 10 percent, and the economy continues to grow rabidly.

The Chilean government has continued with reforms: pension schemes have been privatized; efficiency in ports has increased so much that Argentinian farmers now try to ship their produce through Chile, whereas Chilean farmers used to try to ship through Argentina; a law rescinding the right of workers with more than six months' tenure to a permanent job stimulated a rapid increase in employment; policy toward agriculture has been greatly rationalized; public welfare programs have been reformed to target them much more closely to needy groups; and financial markets have been gradually liberalized.

In contrast to Turkey, Chile's economic prospects appear to be good; there is no obvious impediment to continued growth at rapid rates over the next several years.

For Chile and Turkey, and all other countries that have embarked on policy reform, current economic policies will require still further reform if accelerated economic growth is to continue (or, in the Turkish case, to resume). In both countries (as in others where policy reform has been launched), there were many who were very skeptical of the potential benefits of reforms when they first started. And in both, most citizens are now believers. From both countries, the lessons may be learned that successful reforms can deliver much more satisfactory increases in real output and living standards and—certainly in hindsight—most support the reforms. It is perhaps reassuring that in both countries th e acceptance of reforms was sufficiently robust so that policy mistakes (Chile's pre -fix and Turkey's fiscal imbalance) did not undermine the benefits of reform. While much remains to be learned, success with reforms to date, and the number of other countr ies now embarked on the process of policy reform, insure that economists will have ample data on which to undertake further research and increase further our understanding of the reform process.

8. Implications for Egypt

As a newcomer to Egypt, it would be presumptuous of me to try to provide a policy prescription for Egypt's economic development efforts. Moreover, I have tried to stress the

importance of analysis of the roles of regulations and distortions in incentives in each individual country in determining the appropriate path of policy reform.

What is clear is that Egypt has been an underperformer in the world development leagues. Per capita income growth has occurred, but much appears to have derived from oil revenues: aside from that, Egypt's rate of growth of per capita income seems to have been very low contrasted with many developing countries and with what seems to be achievable, based on the performance of other countries.

Moreover, given Egypt's location and apparent comparative advantage in a highly industrious unskilled labor force, it would appear that the payoff for successful policy reform in Egypt would be very great. Indeed, it can be argued that the world needs one or several countries with relatively abundant unskilled labor to step up as major exporters of some of the products previously supplied by Southeast Asian and East Asian exporters in their earlier stages of development. Egypt appears to be a good candidate.

To date, it seems evident to an outsider that the government has pursue d a number of economic objectives, not all of them compatible with rapid economic growth. While many of these objectives appear worthwhile, one wonders whether a commitment to rapid growth with swift policy changes would not yield more resources, even in a relatively short period of time, with which to pursue these objectives than the fairly slow growth of the recent past.

A key lesson from other countries is that the transition to policies conducive to rapid growth will be successful only when policymakers succeed in convincing everyone of their commitment to rapid growth and an outer-oriented trade policy. In a sense, that requires an almost single-minded commitment to growth with little regard for other desirable objectives, at least in the short run.[29] When development is but one of many objectives of economic policy in the short run, the prospects of reforms of sufficient magnitude to alter the future growth trajectory are relatively weak.

There is no reason why Egypt could not become the 'next Korea' or the 'next Taiwan.' But to do so will require a commitment and a focus on economic policies and integration with the

[29] To be sure, one could attempt to achieve growth in ways that were inconsistent with poverty alleviation, but experience is that for countries abundant in unskilled labor, the key social objectives of improving the lot of the poor are consistent with a rapid growth development strategy.

international economy, with the full energy of policymakers and bureaucrats devoted to the effort. Believing that rapid growth is attainable is a first step; significant changes in trade policy and other impediments to an outer-orientation are the next step. Once growth accelerates, next steps—which entail still further policy reform—become more obvious and less difficult.

PART II

TOWARD A TRADE POLICY FOR EGYPT

Participants in the discussion following Dr. Krueger's presentation included: Adel A. Beshai, Arvind Subramanian, Ahmed Galal, David Jessee, Gala El Zorba, and Samir Korayem.

Participant: What's the difference between subsidy and incen tive as instruments of promoting exports?

Speaker: Those two terms can be used interchangeably, and of course anything that provides a subsidy is giving an activity more incentive than it would otherwise have. On the other hand, the term 'incentive' has been used in policy discussions for the most part as more or less automatic and across the board. Normally, subsidies turn out to be more industry -specific, which tends to involve a great deal of bureaucratic discretion, a great deal of delay. It's no longer automatic, and I think that in general you are not going to get terribly far with a trade strategy where you depend on subsidies that are industry - or activity-specific. Uniform, across-the-board incentives, such as the exchange rate, have a much better c hance of success.

Participant: Your discussion of Korea is very enlightening. I visited Korea three times and each time I was surprised. Firstly, the country was highly disciplined: I compare it to a military system, and I noticed of course the absence of democracy, if you may say that. Second was the high foreign exchange control, and this I noticed in the 1980s and until 1992. People wanted to have dollars instead of hwans, which reminds me of Egypt before the last reform. My question is how much of the rapid growth that Korea had is due to discipline and foreign exchange preservation?

Speaker: That's a good question, but it is hard to answer. I can give you some impressions. Firstly, Koreans have been highly disciplined since the 1960s, but they were not in the 1950s. The chaos in the Korean government in the 1950s shows that something else changed too. I am

talking of the single-minded focus. The single-minded focus did come to be on exports, almost too much so by the 1990s. They're now backing away from it a little. Secondly, they did not accumulate foreign exchange reserves; in fact, they borrowed heavily from abroad. I am astonished sometimes when I look at the numbers. No country has ever run more than an 8 percent GDP current account deficit for more than two or three years without running into difficulties. Korea ran 10 percent for, I think, seven years in a row in the late 1960s as their savings rate was rising, but as their opportunities for productive investment were high.

I would say they were not disciplined with regard to foreign exchange for production purposes, but they were for consumption purposes. If you had gone to Korea and tried to buy a bottle of wine or play a round of golf, you would have been shocked, because the price was prohibitive. All the consumption things were frowned upon, as the entire society seems to have gotten this 'let's-increase-productivity' mentality. One of the interesting things as the Korean authorities have (admittedly too late) begun to relax some of these antico nsumption biases (which are true for domestic as well as for imported goods) has been how little response there has been, because people are busy saving, people are busy improving their net asset position, and there seems to have been a societal consensus on this. Walking around about 3:30 in the afternoon in Korea is remarkable because you see all the high -school-age kids: half of them are going to high school, having already done their work for the day, and the other half are leaving high school to work for the day. This commitment of the entire society to this unbelievable level of economic activity is truly remarkable, and it may not be worth it.

I have a former student who is a professor at a Korean university, and I'm a sort of godparent to his two children, who were born in the United States. When I was taken to see the children about 11 o'clock at night, the parents allowed the boy (who was taking his entry exams for university) to take a half-hour off from his tutor to see me. The poor boy: after fi ve minutes he was so nervous he went back to the tutor—he didn't want to be away from his studies. There is this kind of overt pressure, and I think the Koreans themselves now worry about it. The parents of this boy say he's studying too hard, and they can 't get him away from it. There is something in that ethic, but I'm not sure how much it's imposed from the top.

As to the absence of democracy, the history is more complicated than is often reported. There was a democracy in the 1950s. That government, by all accounts completely incapable of

governing, was overthrown in a so-called student revolution. Whereupon a military junta took over and then arranged for democratic elections in 1964, when President Park was elected with great popular support. He was reelected in 1968. There have been no allegations that that election was particularly interfered with. Quite clearly, the basis for his popularity was that he was delivering very rapid increases in living standards in a very poor country. That was his legitimacy. The same thing in Chile: Pinochet was no democrat, as we all know, but when finally there were moves toward democracy back in the late 1980s, even those who had opposed the reforms were campaigning on a platform that they would maintain the economic policy. So I think I would distinguish between 'is it true that it's democracy?' and 'is it true that people support the economic policies?'

Secondly, there are political scientists who have done a lot of work on just what is the relationship between growth and democracy. We always focus on Korea, Taiwan, and Pinochet of course, and say that's a little bit authoritarian, and that must be what it takes. But political scientists don't find a relationship, because what we forget is the Idi Amins in this world, who are also dictators and who had nothing to do with growth, and we forget some of the more successful growth cases where there was a democracy. New Zealand has had more far-reaching economic reforms than any country in the world in the 1980s and 1990s, and nobody has questioned their total commitment to democracy—this has been done through a democratic process. So the political scientists that I know at least say you can have dictatorships that have good economic policy; you can have dictatorships with bad; you can have democracies with good; democracies with bad.

I hope and I believe it is also true that you cannot have rapid growth for twenty or thirty years without developing a much more healthy and a much more vibrant middle class and a much more vibrant group of professional and technical workers. I do not think that professional and technical workers can be productive and then be asked to be less free—they are going to want more participation in the political system. And in that sense I think that if one saw an absolutely hopeless economic situation under a dictatorship, one might nonetheless work to free up the economy on the theory that, first off, anybody who's going to have an open economy cannot repress the press too much or cut off the telephones, so that already freedom of speech is in a way insured. And secondly, as growth persists, quite clearly I think the

opening of the political process is going to have to follow if growth is to be sustained. I think that's the Chinese dilemma right now, and has been since 1989. I think they're in real trouble over it because they are getting a bigger and bigger group of people who want a say in things. Certainly, you saw a Korean opening in the 1980s. We've had an opening to some extent in Taiwan. And Chile has moved toward democracy. So I think the argument can be turned around: you cannot have sustained growth for a long period of time without some political liberalization as well.

Participant: I was surprised that you didn't once mention the word corrup tion: it would be very useful to have your views an the effects of that on economic development.

But I wanted to turn to your very illuminating discussion of the Korean experience, because it's the sort of child prototype of import-substitution. I'm an Indian and I am also an honorary Egyptian here. When you tell Indian policymakers, Egyptian policymakers, and anyone else to liberalize faster, they all say no, and they invoke the Korean experience. I think that the comparison with Korea is instructive for what not to do and how not to do it—for two reasons. Firstly, the world trading environment is now completely different: you have the World Trade Organization, with fairly stringent rules, applicable even to developing countries on export subsidies and all kinds of subsidies. Secondly, I think the Korean experiment, in terms of what they did—slower reduction and protection, but very sophisticated intervention to neutralize incentives between exports and import substitutions—presumed a lack of government failure in the sense of having a high level of education, a skilled bureaucracy, and strong institutions ready to implement reform without leakages and without corruption. Now, if these two elements hold in a hypothetical country called Egypt—which doesn't exist in reality—then the conclusion has to be that you can't really proceed in terms of the Korean rules, saying you go slowly on tariff reduction and trade liberalization but try to do all these really complicated fixes. That doesn't work. In fact, you have to do simple, straightforward things like reducing tariffs and getting rid of your controls as the quickest and most efficient way to reform, given government failure, given the new world trading environment, and given the level of bureaucracy. May we have your comments on that?

Speaker: Well, where to start? Lack of government failure. If you took Korea in the late 1950s, you had government failure like mad, you had corruption as well. In fact, if you go back and get the headlines translated—as I had a graduate student do for a couple of months—and count the frequency of the scandals and the corruption in the headlines at that time, you find the major reason the government was overthrown was that it was so very corrupt. And it was corrupt over import licensing and the very things we are talking about.

The skilled bureaucracy that you referred to is a bureaucracy that became skilled when Korea became reoriented toward delivering the infrastructure and what-have-you—I don't know about the Egyptian bureaucracy, but certainly in countries that had or were reputed to have a skilled bureaucracy, which could be put to good use, it was reharnessed. India certainly was very high on the list. Nobody could quarrel with the quality of the bureaucracy, but that bureaucracy of course got tied into making all the same kinds of regulations. And that, it seems to me, is the path of death for a bureaucracy, because no bureaucracy can be skilled and remain impervious to the kinds of difficulties that arise in that kind of an incentive system.

If you talk about level of education, that one really puzzles me, because what's always forgotten is that Korea was a Japanese colony until 1945. No education in Korean was permitted until 1945, which goes to show that nobody over fifteen in 1960 (which is when the reform started) had been educated in the Korean language. Korea had an educational deficit of fairly major proportions. The Japanese did not think Koreans were smart enough to get university education, even in Japanese. If you want a country with a colonial legacy that has lots of negatives to it, Korea certainly has to be on that list, so I don't find the education argument compelling in any of these countries, including India today and Egypt today. I have no idea what Egyptian education systems look like. There is still a pyramid of people enough toward the young end that educational reforms can very quickly deliver very large changes in the role of the supply of people of various skill levels. Korea developed its highly educated working force after 1960.

You talked about the world trading environment. The only thing I know of that is significantly different today is, of course, that the WTO rules and the antisubsidy policy are more strongly enforced than they were earlier on—and that says use the exchange rate, instead of using the effective rate as the Koreans did. That's all it says. I did not say the Korean policy

was one of deliberately going slow. They went as fast as they could. What I said was that they could not go any faster because of built-in political and other reasons. Now, I would agree with you that today it becomes more important both to bring down protection faster and also to move the level of the exchange rate more rapidly. I think those two things go together , and I think that the exchange rate piece of the puzzle is the one that is often forgotten in trade liberalization.

In Mexico for example, the Mexican authorities were looking at their real exchange rate and saying, we're fine. What they forgot was that in 1985 they had 85 percent of their imports subject to quantitative restrictions. In 1988 they had lowered tariffs enormously and they had almost no import-quantitative restrictions, and in calculating real exchange rates they made no allowance for that, and that makes a huge difference. The minute you give discretionary policy to bureaucrats, you get into a situation in which the bureaucrats are allocating licenses of enormous value and people are trying to get permissions that have value to them. Implici t in my discussion of market–government relations is that I want bureaucrats to try to increase exports and not to try to regulate the private sector. I want the private sector to see the government as supportive of its activity in general but not as a pla ce it goes to for special favors.

Participant: I have two comments. The first has to do with the motivation for adopting import substitution. You seem to be saying that policymakers in developing countries followed a strategy of import substitution—the fashionable strategy of the fifties—with the infant-industry argument in mind. It seems to me that policymakers in Egypt and other countries followed import substitution because it was considered a blessing in itself. Someone following an infant - industry argument would have been a more sophisticated person, and they followed import substitution not with infant industry in mind—but to industrialize for industrialization's sake, to industrialize because industrialization is synonymous with development: that was the mentality. Moreover, when we look at Egypt, without the argument of infant industry some of our most prominent and successful industries would not have existed. Textiles, for example: you had to have some protection, and you could then compete in the w orld market. In that respect the tariff, the protection helped create industries with competitive advantage. Ceramics, for example: there had to be protection in the seventies, and now we are competing at the world

level in Spain, in Italy, and elsewhere. I feel that the proponents of import substitutions were being simplistic, but an infant-industry mentality is another kettle of fish.

The second comment I want to make is this: trade liberalization is all very well, but we also need to talk about trade liberalization by one country in the context of specific world trade circumstances. Are we talking partial equilibrium or general equilibrium analysis? Experience from Egypt can give us a few insights. Years ago, it took us a year and half to negotiate with the United States to raise our quota for selling manufactured textiles from $30 million to $90 million. So what trade liberalization? You mentioned that Chile is a success story, and I agree. The major export of Chile is fruits and vegetables. Forget industry now for a moment: Egypt has a tremendous potential in fruits and vegetables. Biggest partners at the moment? Western Europe. Even with the clauses of the GATT and so on, we could one day earn hundreds of millions of dollars from asparagus, tens of millions of dollars from sweet peas. But then you have quotas in these markets. This reminds me of an article I read on the first page of the IMF survey four years ago, entitled "Increased Protectionism in the Developed Countries." I wish you would talk a little about trade liberalization—which doesn't just boil down to import liberalization—in the context of what is happening in the rest of the world, and in the context of regional groupings.

Speaker: You talked about the distinction between import substitution and native industry and your judgment is that textiles and ceramics and so on needed protection. If I'm right that trade liberalization works, and there is some comparative advantage potentially in some industries, then a well-defined, outer-oriented trade strategy with sufficient incentives would have brought forth the right infant industries. If you think about Egypt in, let's say, the 1960s and the 1970s under an alternative regime, perhaps with a significantly more depreciated real exchange rate and at the same time an open import regime, one kind of question is: might not the textile industry have developed in an even more healthy way or more rapidly than it in fact did? There have recently been economic historians going back in US economic history (and one of the arguments has always been that the US steel industry developed under protection) and asking: is it true that protection in the US helped develop it? And they're finding the answers in the negative, that these industries grew more slowly. It wouldn't surprise me to find that the textile

industry grew less successfully than it would have grown if it had not had protection but indeed had been subject to this more uniform trade machine—but that's speculation.

Turning to trade liberalization in the context to the rest of the world, the first thing I'd say is that the evidence is strong that 90 or 85 percent of the gains from the outer-oriented trading strategy, for example in Korea or Taiwan, were gains to Korea and Taiwan because their producers were confronted with an environment in which they had greater incentives for productivity gain. It isn't true that the major gains came because they exported: it is true because they had competition, because they had incentives to do things in productive ways. Having new markets expand more rapidly helped with that as well. In India in 1950s the whole thing was: we can't go outer-oriented because they will never accept our markets. Brazil and India have been the two leading the charge, saying the world markets are closed, we cannot export more. They have said it consistently since the 1950s; they have been wrong since the 1950s. Since the 1950s, the developed countries have increased their array of imports from developing countries more rapidly than they have increased their own growth rate. They have increased their overall trade more rapidly than their GDP. In China the increase in exports in the past ten years has been astronomical.

I think that protection hurts the United States as well, and I don't like it. There's no doubt we could benefit from an even more open trade regime that would help all of us. Liberalizing more would help the developed countries even more than it would help the developing, and the benefit goes to the liberalizers because they've got the top position, they've got the incentives right, and they're productive. So I don't buy the argument that because we have quotas in the world, therefore you can't do it. I do buy the argument that those quotas are not a good thing, but that isn't the same thing. Because other countries impose quotas on us that harm us, we should therefore impose more quotas on ourselves to harm ourselves more? I fear this is something of the logic of "we have to worry about the world economy." And the other point is that when you're starting from a relatively small base, and if you get your incentives right, it is not going to be all textiles and apparel or all footwear and whatever: the number of things that start up that you and I can't even dream of is large, and the markets for those things are much more open.

A final comment. It is my considered opinion that if Egypt and if Turkey and if Brazil and if India worked a little harder in the Uruguay Round of Negotiations and, come the next round, pushed even harder for, for example, agricultural liberalization, you wouldn't get total freeing of agricultural trade right away, but instead of getting tariffication plus about two percentage points liberalization (which is all we got in agriculture), we might have gotten fi ve. Well, if next time we started with five, the following time it might be twenty. If developing countries are silent and we stay at two, next time we'll get eight. It is not going to happen all at once, but it's in the right direction. Remember, we're su pposed to have a phase-out of the multi-fiber agreements (MFA) within ten years, and I would hope to see some political pressures from developing countries to make sure that sticks. I think there are things that developing countries can do, and in the past instead of doing them they've gotten inter-oriented and therefore those things haven't happened.

Participant: What policymakers in Egypt or another country are really asking is, suppose they do want to move away from import substitution and promote expor ts: how to do it? The road to liberalization is not unique—there are many ways of getting there—and it is not always clear which one to follow. In the story of Korea, you told us how they started off with a nominal exchange rate, added the export subsidy, added the tax subsidy, added whatever, and then at the end of the day what they were really trying to do was to equate the effective incentives facing importers and exporters to provide a level playing-field. But that's one way of doing it, and the fact that Korea has done it that way doesn't necessarily mean that somebody else is well advised to do the same. Are there other ways, better ways, smarter ways, less inefficient ways of doing it? What's wrong with simply neutralizing the bias against exports by reducing tariffs and working on the exchange rate? And maybe there's a transition period that countries have to go through. But can one say something useful in hindsight, learning from the Korean story as well as other places that one rule is a lot more ef ficient than another?

Speaker: Quite clearly there are many routes, and quite clearly you can get there more slowly or more quickly. I take it that for poor countries such as Egypt and India there is some desire to get there more quickly, and I also think that convincing everybody that everybody is committed to the strategy is terribly important, so that the strategy will stick. The countries that have relied

on the exchange rate as an alternative have very often been somewhat slow in removing protection from import-competing industries, which is somewhat my concern. In India, for example, we hear all about these marvelous reforms: the fact is, consumer goods imports are still not permitted, and simultaneously there's been exchange rate freeing -up. But obviously if you were an Indian producer you'd much prefer to go look at that nice domestic protected market than go out and really have to start working hard in the international market. That's still an alternative, so using the exchange rate—which is what I think the ideal was—does require the removal of protection on imports very, very quickly. And I don't mean only the obvious protection, I mean removal of bureaucratic protection, which can sometimes be more costly.

One of my former students in Korea, who was in the government and believed in liberalization, discovered that what was protecting Korea against imports of automobiles was not so much the tariff (although that was very high) but in addition the safety inspections of automobiles. He had been able, given his position fairly high in the government, to remove the protection. But when he did that—for automobiles this went from about 150 percent to zero—he looked at the import figures three months later and nothing had happened. Then he went and looked at what had happened in the ministry of transport. The ministry of transport had been testing one car out of every thousand as they brought them in, to make sure they met Korean safety standards. When the regulation of the tariffs had changed, the ministry of transport had decided that they were afraid those cars might constitute a safety threat to Korean consumers, so they put out a new regulation that every single automobile being brought into Korea had to be test-driven ten thousand miles under Korean conditions before they could go on Korean roads. Well, they only had two test drivers, so you can imagine what happened! So they had to get that stopped—and getting rid of that kind of thing in some countries can be very difficult, and sometimes those guys can actually keep ahead of you. This is why I tend to think that if there is a WTO-consistent way to get something in the meantime that increases the reward to exporters to offset all of this kind of hidden protection stuff, this can be a useful intermediate step.

The second comment I would like to make, though, is that some successful reformers made mistakes. This includes Chile in the late 1970s. I mentioned their big policy mistake. They had gotten exports growing. They had done a lot right. They still had a fairly high rate of inflation.

They decided the way to bring inflation down was to fix the nominal exchange rate. They didn't fix it to no change, because they knew that would be too much. Rather, they fixed it in such a way that the change in the exchange rate would be compatible with an annual inflation rate of about 30 percent. Well, inflation was 75 percent, the result of which was that the Chileans got real appreciation in 1979, 1980, and 1981, and then, of course, the regime broke. The same was exactly the Mexican problem in 1994. They had a long period of time when they were using just a preannounced exchange rate, but they got real appreciation of exchange rate and ran into difficulty.

A major problem is that governments very often want to use the exchange rate as an anti-inflation device, which is fine and good up to a point, but unless you've really got monetary and fiscal policy under control the policy can be costly. Now producers anywhere in the world are really smart. They're not out there spending the taxpayer's money, they're spending their own, and when they're spending their own there's a little bit more incentive to be careful. When they see that the government is going to be tempted to do this, they form their own expectations and behave accordingly. I was in Chile in 1981 or 1982 talking about exchange rate policy, and I basically was arguing for a policy with a much more flexible exchange rate. Afterward, a major producer of copper came up to me and said, you know, all you said is fine and good in theory, but any time the price of copper rises on the world markets, the Chilean government is going to want a chip. Every producer in Chile knew exactly what drove that exchange rate mechanism, and until you can change expectations you've got problems with relying on the nice neat textbook device, because the political economy of how the exchange rate gets determined is not the political economy you'd really like to have. Getting the exchange rate so it's geared to trade policy and getting fiscal monetary policy geared to inflation is where you want to get to as fast as possible. If you can do it right away, wonderful. That's the best option. But I'm not always sure that you can.

Participant: I believe both countries you have focused on—Korea and Chile—have decent relationships with Egypt: there has been some interchange of business and such. I wonder if you have seen in the experience of either of those two countries that they have an effective way to help countries that would like to emulate their experience. In other words, are they organized

as providers of advice, organizing trips or whatever? We certainly appreciate, I think, in both cases, the fact that they are held up as models. Are they ready to play that role with countries such as Egypt, in hosting a program of interchange?

Speaker: I don't know what there is at the official level. I think probably not too much. I do know that most of my Chilean economist colleagues are busy going around the world talking about how they did it. So I know there is a booming private business there. I also recall that when the Chilean economists were trying to persuade the government of the reforms, they were very busy bringing in people for various conferences, and in particular I recall an occasion when they had economists from East Asia come to Santiago talking about how it had been in East Asia.

APPENDIX

LIST OF ATTENDEES

Adel A. Bishai
Chairman, Economics Department, The American University in Cairo

Ahmad Abdel Salam Zaki
Chairman and Managing Director, Credit Guarantee Co. for Small Scale Enterprises

Ahmed Ezz
Member, ECES; Ezz Group

Ahmed Galal
Executive Director, ECES

Al Motaz Bellah Ahmed Mansour
Managing Director, Misr Iran Development Bank (MIDB)

Ali Soliman
First Undersecretary, Ministry of Economy and International Cooperation

Anne L. Terio
Contracting Officer, Procurement Office, USAID Cairo Mission

Arvind Subramanian
Resident Representative, IMF

Ashraf Mahmoud
Senior Vice President, Al Ahly for Development and Investment (ADI)

David Jessee
Project Officer for Privatization, TIFI, USAID Cairo Mission

Fiona Moffitt
Country Author, The Economist Intelligence Unit

Fouad Sultan
Chairman and Managing Director, Al Ahly for Development and Investment (ADI)

Galal El Zorba
Vice Chairman, ECES; Nile Clothing Co.

Hala El Barkouky
Partner, Allied Business Consultants (ABC)

Hamed I. Fahmi
Managing Director, Allied Corporation

Hassan El Shafei
President, International Office Equipment

Hoda El Sayed
Associate Professor, Faculty of Commerce, al -Azhar University

Hussein Derar
Director, Data Bank Department, Ministry of Foreign Affairs

Ibrahim Fawzy
Executive Director, General Authority for Investment

Jonathan Wright
Chief Correspondent, Reuters

Kamal El-Kheshen
Head of Operations, African Export–Import Bank

Mahmoud Abdel Fadil
Professor, Economics Department, Faculty of Economics and Political Science

Nagui El Fayoumi
Special Assistant to Associate Director, Trade and Investment, USAID Cairo Mission

Osama Abdel Wahab
Chairman, El Nasr Castings Co.

Raouf Saad
Deputy Assistant to the Minister of Foreign Affairs for Regional Economic Cooperation, Ministry of Foreign Affairs

Rebecca Maestri
Project Officer, *USAID Washington*

Robert Wagner
General Manager, Carana Corporation

Roushdy Abdel Kader
Head of Commercial Representation and First Undersecretary, Commercial Representation Office

Sallama Shaker
Deputy Assistant Minister to North America Affairs, Ministry of Foreign Affairs

Samir Korayem
Consultant

Thomas Rishoi
Associate Mission Director, Program Development & Support, USAID Cairo Mission

Toni Christiansen-Wagner
Deputy Mission Director, USAID Cairo Mission

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